ST 01-0019-PLR 05/29/2001 COMPUTER SOFTWARE

This letter concerns whether the contract in question meets the criteria of 86 Ill. Adm. Code 130.1935(a)(1) to qualify as a nontaxable license of software. (This is a PLR).

May 29, 2001

Dear Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (see enclosed), is in response to your letter of March 2, 2001 and your follow up letter of May 11, 2001. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

In your letter of March 2, 2001, you have stated and made inquiry as follows:

> The purpose of this letter is to request confirmation from the Illinois Department of Revenue that transfers of software pursuant to software licenses granted under COMPANY's current software license agreement are not taxable retail sales under the Illinois Retailers' Occupation Tax. This matter is not under audit or in litigation. As discussed below, the Department has previously ruled favorably on a similar issue. Apart from the ruling discussed below, no similar ruling request has been submitted but withdrawn prior to the issuance of a ruling. I am unaware of any authority contrary to the position stated in this request.
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> **Background**
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> In April 1995, the Department of Revenue issued a letter ruling confirming that COMPANY's then-standard Software License and Services Agreement ('SLSA') qualified as a software license not subject to Retailers' Occupation Tax under regulation 86 Ill. Adm. Code 130.1935(a)(1). A copy of correspondence exchanged between the Department of Revenue and COMPANY, including your April 6, 1995 letter confirming the exemption, are attached to this letter under **Tab A**.
> In an effort to streamline the contracting process, COMPANY recently revised its standard license agreement – now called the 'COMPANY License Agreement' or 'CLA'. A copy of the CLA and its accompanying documentation is attached under **Tab B**. The CLA is consistent with its predecessor, the SLSA, with respect to satisfying the criteria established by Retailers' Occupation Tax regulation 86 Ill. Adm. Code 130.1935(a)(1)(A)-(E) for a nontaxable software license.

Below, I will demonstrate that the CLA satisfies each of the five criteria set forth in 86 Ill. Adm. Code 130.1935(a)(1)(A)-(E).

130.1935(a)(1)(A) The License is Evidenced by a Written Agreement Signed by COMPANY and the Customer

The customer signs documents comprising the entire license agreement. In each transaction the customer is presented with: (1) the CLA which contains the general license term; (2) an Ordering Document which sets forth the custom terms of the transaction, including the specific programs being licensed, the methodology of calculating the license fee, the shipping instructions, etc., and, (3) a set of standard definitions and licensing rules. The customer and COMPANY sign the Ordering Document that incorporates all of the terms of the CLA. See **Tab B,** Ordering Document, at page 2, which provides that:

> This ordering Document is placed in accordance with the agreement specified above ('Agreement')

The 'Agreement' referred to is the CLA, Version 25. The customer receives a signed copy of the Ordering Document for its file.

The incorporation of the CLA into the Ordering Document satisfies this criterion. In PLR No. ST 99 – 0017, the Department of Revenue determined that a similar incorporation by reference met the requirement. The taxpayer there stated that 'all orders are supported by a sales supplement which references our standard terms and conditions.' The Department's ruling stated that:

> We find that requirement (A) above is met by the Object Design, Inc. Order Supplement when the Object Design Standard Shrink-Wrap Terms and Conditions are incorporated by reference as part of the signed agreement.

The COMPANY Ordering Document stands on the same footing.

130.1935(a)(1)(B) The License Restricts the Customer's Duplication and Use of the Software

At **Tab B**, the second paragraph of the CLA titled 'What This License Agreement Covers' limits the customer's right to use the programs for its 'business operations' and subject to the terms of the license agreement and program documentation. The third paragraph titled 'Ownership and Restrictions' sets forth a series of restrictions on use, and forbids duplication without COMPANY's approval except to the extent consistent with the customer's licensed use and for backup purposes. The restriction on duplication and use element is easily satisfied here.

130.1935(a)(1)(C) The License Prohibits Sublicensing or Transferring to Third Parties

Your April 6, 1995 letter (at **Tab A**) finds this element is satisfied by the SLSA because it 'prohibits the customer from licensing, sublicensing or transferring the software to a third party without consent of COMPANY.' The CLA does the same, and is in fact more

restrictive. At **Tab B**, the second paragraph entitled 'Ownership and Restrictions' prohibits the re-licensing, renting or timesharing of the programs. It further provides that the customer is barred from assigning the license, or an interest in the programs, to another individual or entity. While the SLSA contemplated the transfer of programs to third parties upon consent, the CLA prohibits such transfers all together since it does not mention COMPANY's consent as a means of avoiding the restriction.

130.1935(a)(1)(D) Copies of Lost or Damaged Software Provided at Minimal or No Charge

At **Tab B**, the second paragraph of the CLA provides the customer may make copies of the programs for backup purposes, so if the software is lost or damaged the customer will have a copy immediately available at no additional charge. In the unlikely event a customer has not made a backup copy of the programs, and provided it maintains an update subscription service, it may order additional CD packs at COMPANY's then-current CD pack price (presently $39.50), an amount that is plainly 'nominal' in view of overall license fees. This provision is found at **Tab B** in the Ordering Document, page 2, paragraph 2.

130.1935(a)(1)(E) Copies Must Be Destroyed or Returned at the End of the License Period

The CLA provides, on page 6 of 6, that, unless a license term is specified, the license is perpetual. The regulation provides that the subject requirement is deemed to be met by a perpetual license. Thus, COMPANY's perpetual licenses satisfy this requirement.

The CLA also provides that licenses can be for two years terms and for four-year terms. The CLA further provides, on page 2 of 6, that

> We may audit your use of the programs. If we give you 45 days advance written notice, you agree to cooperate with our audit, and provide us with reasonable assistance and access to information. You agree to pay any underpaid license, hosting and technical support fees.

This provision gives COMPANY an ongoing right to audit the customer's use of the programs. If COMPANY's audit were to disclose that a license had been used beyond the two or four-year term granted, the customer would have to pay any underpaid fees. This legal obligation to pay fees for any use of the program after the end of the term that is otherwise authorized is perpetual. Thus, if the customer were to make a use of a program that was subject to a two or four year term after the expiration of that term, the customer would incur a liability to pay for its unauthorized use. This requirement means that the customer never has the right to use the program without incurring an obligation to pay COMPANY a license fee. The two and four-year term licenses accordingly fall within the provision that perpetual licenses are deemed to meet the regulation's requirement.

Request

I respectfully request a letter ruling from the Department of Revenue confirming that COMPANY's CLA qualifies for treatment a nontaxable license under the Illinois Retailers' Occupation Tax. However, if you disagree with any of the conclusions urged

herein, or if you have any questions, I would appreciate it if you would contact me to discuss any disagreement or questions before you respond to this letter.

Thank you in advance for your time and attention to this matter.

In your letter of May 11, 2001you have stated as follows:

This will confirm our recent telephone conversations relating to the questions you had on my February 23, 2001 request for a private letter ruling.

You asked for clarification of the provision in the COMPANY license agreement on which COMPANY relies to comply the requirement, in 86 Ill.Admin.Code Section 130.1935(a)(1)(D), that the licensor agree to provide a copy of lost or damaged software at little or no charge. The license agreement provides, in the Ordering Document, page 2, that:

> 'If you lose or damage the media containing a program licensed hereunder, upon your written notice we will provide a replacement copy thereof, under our then-current Technical Support policies, for a media and shipping charge.'

With respect to the question you raised about the two and four-year licenses mentioned in the agreement, this will confirm my request that the Department of Revenue defer ruling on the two and four-year licenses pending the submission of material that should answer your question.

Please consider the request to now be limited to a request for a private letter ruling relating to the perpetual licenses only.

Based upon the representations made and the materials provided, specifically the COMPANY License Agreement, Version 25 (CLA) and the Ordering Document, it is our position that the CLA together with the Ordering Document, as referenced, comprise a license of software not taxable under the Retailers' Occupation Tax Act.

If transactions for the licensing of computer software meet all of the criteria set forth in Chapter 86, Section 130.1935(a)(1) of the Illinois Administrative Code, neither the transfer of the software nor the subsequent software updates will be subject to Retailers' Occupation Tax. A license of software is not a taxable retail sale if:

A) it is evidenced by a written agreement signed by the licensor and the customer;

B) it restricts the customer's duplication and use of the software;

C) it prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) without the permission and continued control of the licensor;

D) the licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make and

keep an archival copy, and such policy is either stated in the license agreement, supported by the licensor's books and records, or supported by a notarized statement made under penalties of perjury by the licensor; and

E) the customer must destroy or return all copies of the software to the licensor at the end of the license period. This provision is deemed to be met, in the case of a perpetual license, without being set forth in the license agreement.

We find that requirement (A) above is met by the CLA. This is because the Ordering Document, which is signed by the customer and by COMPANY, incorporates the CLA by reference and states that "[t]his Ordering Document is placed in accordance with the agreement specified above." Also, the CLA incorporates the Ordering Document by reference and states that "[t]his license agreement includes the terms provided below and the terms of the order which you have previously completed." Therefore the signed Ordering Document taken as part of the CLA results in a written agreement signed by the licensor and the customer.

We find that requirement (B) above is met by the CLA's provisions under "What This License Agreement Covers" and "Ownership and Restrictions" that restrict the customer's duplication and use of the software.

We find that requirement (C) above is met by the CLA's provisions under "Ownership and Restrictions" that prohibit the customer from re-licensing, renting, leasing, timesharing or assigning the licensing agreement.

We find that requirement (D) above is met by the "Ownership and Restrictions" provisions of the CLA which provide that the customer may make a sufficient number of copies of each program for its licensed use and one copy of each program for backup purposes when its system is inoperative, but must obtain approval from COMPANY to make any additional copies. Requirement (D) is also met by the "Miscellaneous" provisions in the Ordering Document that provide that if the customer loses or damages the media containing a program subject to the license, COMPANY will, upon written notice, provide a replacement copy thereof under its then-current Technical Support policies, for a media and shipping charge.

We find that requirement (E) above is met in regard to COMPANY's perpetual licenses by the provisions in the CLA under "Term Designations." As requested, the Department will reserve ruling in regard to COMPANY's 2-year term and 4-year term licenses, pending the receipt of further information.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

I hope this information is helpful. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Martha P. Mote
Associate Counsel

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